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Banks may continue raising interest rates this fiscal year; deposits now playing catch-up with lending rates

Reserve Bank of India (RBI) continuing to tighten the repo rate to suck out excess liquidity and tame inflation, interest rates are expected to continue upward march, analysts at CareEdge said.

Written by Kshitij Bhargava
August 15, 2022 12:09:52 pm

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With the Reserve Bank of India (RBI) continuing to tighten the repo rate to suck out excess liquidity and tame inflation, interest rates are expected to continue upward march, analysts at CareEdge said. The rating and research firm, in a recent note, said that it has observed that both public, as well as private sector banks, continue to maintain high spreads between lending and deposit rates. Although the up-move in lending rates, as of now, is sharper than deposit rates, analysts expect that would narrow down soon. "CareEdge anticipates that the rise in deposit rate would pick up steam given the fact that the credit growth has picked up and the liquidity is narrowing in the banking system," they said.

The RBI's Monetary Policy Committee (MPC) has undertaken a total of 140 basis point repo rate hikes since May this year. The central bank is attempting to bring down inflation which remains above its 2-6% tolerance band. In July, retail inflation stood at 6.71% from 7.01% in the month of June.

Banks pass on rate hike

Banks are expected to continue hiking their interest rates as RBI ups the policy rate this fiscal year. The up-move in policy rate comes as the central bank, akin to peers across the globe, looks to pull out excess liquidity and trim inflation. "RBI has been working on reducing the liquidity surplus in the banking system which has been consistently reducing and is currently around the Rs 2 lakh crore mark from Rs 7 lakh crore at the beginning of 2022," CareEdge noted.

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In the month of June, the weighted average bank lending rate (WALR) on loans for PSBs, private banks, and SCBs increased by 16 bps, 9 bps, and 14 bps, on-month, respectively, passing on the policy rate hike. WALR on fresh loans incorporated the rising interest rates faster as it increased for PSBs, PVBs and SCBs by 18 bps, 11 bps, and 8 bps, respectively, according to CareEdge.

Deposit rates rise slow

Although lending rates have been increased in tandem with the moves made by the Reserve Bank of India, the rise in deposit rates has been slower than the increase in repo rate. "Deposit rates for PSBs, PVBs and SCBs too witnessed a rise by 4 bps, 6 bps, and 6 bps on-month respectively, in June 2022," analysts noted. But banks are expected to soon bridge the divide. "Going forward, reducing liquidity and rising credit offtake are anticipated to create demand for deposits, which could prompt banks to further raise rates."

Spreads increase

"SCB's spread between WALR (O/s) and WADTDR (the net interest rate spread) stood at 3.8% in June 2022. The spread for PSBs, PVBs and SCBs increased by 12 bps, 3 bps and 8 bps m-o-m, respectively in June 2022 due to a higher rise in lending rates as compared to deposit rates," CareEdge said.

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Analysts also noted that the elevated yields on G-sec bonds are encouraging corporate borrowers to shift borrowings to the banking system from the capital market. "The spread has been contracting due to rising yields in the capital market. However, in June 2022, the spread increased as banks raised rates and yields moderated a bit," CareEdge said. The spread between the 10-year G-sec yield and the lending rates for SCBs came in at 1.5% in June 2022 rising by 15 bps compared to the previous month whereas PSBs and PVBs rose by 17 bps and 10 bps, respectively in the same period.